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The Nature and Scope of the Reliance Requirements in Private Actions under SEC Rule 10b-5

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Erratum
Page 366, line 5: For "uniformed" read "uninformed".

NOTE

The Nature and Scope of the Reliance Requirement in Private Actions Under SEC Rule 10b-5

Reliance has long been viewed as an indispensable element in the plaintiff's cause of action under Securities and Exchange Commission rule 10b-5. The author suggests that it is inaccurate to characterize the reliance requirement as a fixed concept common to all private actions arising under 10b-5. Rather the nature and scope of the reliance requirement are molded by a variety of factors which are analyzed in this Note. In the course of the analysis several important distinctions are discussed, including the relationships between reliance and materiality, actual reliance and reasonable reliance, and causation and reliance.

I. INTRODUCTION

Since the late 1940's when the courts first began to recognize an implied private right of action[1] under Securities and Exchange Commission (SEC) rule 10b-5,[2] they have had difficulty defining the scope of this cause of action. Although courts have relied heavily on concepts borrowed from common law and equitable fraud, the policy bases of rule 10b-5 have precluded a wholesale carryover of the ancestral elements. This difficulty, aggravated by occasionally turbid court discussions, has resulted in a plethora of articles attempting to clarify the law relating to rule 10b-5 generally, and recently the specific element of reliance has attracted the attention of several commentators.[3] The purpose of this Note is to analyze

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[1] *E.g.*, Osborne v. Mallory, 86 F. Supp. 869 (S.D.N.Y. 1949); Speed v. Transamerica Corp., 71 F. Supp. 457 (D. Del. 1947); Kardon v. National Gypsum Co., 69 F. Supp. 512 (E.D. Pa. 1946).

[2] 17 C.F.R. § 240.10b-5 (1970), promulgated pursuant to § 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) (1970) [hereinafter cited as Exchange Act]. Rule 10b-5 provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
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> (a) To employ any device, scheme, or artifice to defraud,
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> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or,
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> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,
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> in connection with the purchase or sale of any security.

[3] *See, e.g.*, Painter, *Inside Information: Growing Pains for the Development of Federal Corporation Law Under Rule 10b-5*, 65 COLUM. L. REV. 1361 (1965); Note, *Reliance Under Rule 10b-5: Is the "Reasonable Investor" Reasonable?*, 72 COLUM.

the reliance notion, and, in so doing, to attempt to dispel some misconceptions that have arisen concerning its parameters in 10b-5 actions.

Generally, before a private plaintiff can recover under rule 10b-5, he must have relied on the defendant's fraud.[4] Reliance in this context requires that one believe the misrepresentation to be accurate and act, or fail to act,[5] because of that belief.[6] Since there are a variety of factual situations that give rise to 10b-5 liability, the foregoing general statements must be qualified. In order to determine the standard of reliance that must be met, or whether reliance is required at all, it is necessary to distinguish three classes of cases: (1) those involving affirmative misrepresentations known by the defendant to be false, (2) those involving negligent misrepresentations, and (3) those involving pure omissions. As a review of these categories will indicate, the reliance requirement is qualified by the concept of reasonableness only in cases involving negligent misrepresentations. In another category — pure omissions — no reliance whatsoever has been required. In the final category — misrepresentations known to be false — actual reliance is necessary for recovery, but arguments can be made in specialized instances that it should not be required at all.[7]

L. REV. 562 (1972); Note, *SEC Rule 10b-5: A Recent Profile*, 13 WM. & MARY L. REV. 860 (1972); Note, *Negligent Misrepresentations Under Rule 10b-5*, 32 U. CHI. L. REV. 824 (1965); Note, *Civil Liability Under Section 10B and Rule 10B-5* [sic]: *A Suggestion for Replacing the Doctrine of Privity*, 74 YALE L.J. 658 (1965).

[4] A. BROMBERG, SECURITIES LAW: FRAUD — SEC RULE 10b-5 § 8.6(1), at 209 (1971). As the analysis which follows will show, this is an oversimplification. Read broadly, the Supreme Court decision in Affiliated Ute Citizens v. United States, 406 U.S. 128 (1972), *aff'g in part, rev'g in part*, Reyos v. United States, 431 F.2d 1337 (10th Cir. 1970), may be taken as negating the need for reliance in all cases. However, this does not appear to be the most accurate reading of the case. *See* note 122, *infra.*

[5] Whether failure to act is a sufficient basis to allow recovery depends upon whether the courts interpret 10b-5 as requiring a purchase or a sale of securities before liability can be imposed. Many courts have imposed such a requirement. *E.g.*, Greater Iowa Corp. v. McLendon, 378 F.2d 783 (8th Cir. 1967), Keers & Co. v. American Steel & Pump Corp., 234 F. Supp. 201 (S.D.N.Y. 1964). It is arguable that a purchase-sale requirement should not be imposed as it would permit wrongdoers to escape liability when the fraudulent scheme has succeeded in deterring the victim from entering into a security transaction. Brief for SEC as Amicus Curiae, Manor Drug Stores v. Blue Chip Stamps, No. 71-2223 (9th Cir. May, 1972). The brief is summarized in [1971-1972 Transfer Binder] CCH FED. SEC. L. REP. ¶ 93,484 (May 1972). *See* Travis v. Anthes Imperial Ltd., CCH FED. SEC. L. REP. ¶ 93,718 at 93,178 (8th Cir. Jan. 12, 1973). A full discussion of this problem, however, is beyond the scope of this Note.

[6] This definition breaks the test for reliance down into its two constituent parts. *See* F. HARPER & F. JAMES, TORTS § 7.13, at 584 & n.5 (1956); W. PROSSER, TORTS § 108, at 714-15 (4th ed. 1971); RESTATEMENT OF TORTS § 546 (1938). For a discussion of a more common, but virtually identical definition of reliance, see text accompanying notes 27-28 *infra.*

[7] *See* note 97 *infra.*

Once the limits of the reliance requirement in each of these categories have been discussed, this Note will distinguish three concepts which are often confused: actual reliance, reasonable reliance, and materiality. The resulting set of subtle distinctions, it is submitted, are consistent with precedent as well as the purposes of the Securities Exchange Act of 1934 (Exchange Act).

II. RULE 10b-5 IN PERSPECTIVE

A. *Purposes of Rule 10b-5*

The purposes of rule 10b-5, and securities regulation in general, are important in understanding the approach the courts have taken in structuring the private action under 10b-5. The Supreme Court, in *SEC v. Capital Gains Research Bureau, Inc.*,[8] referring to securities regulation generally, stated: "A fundamental purpose, common to these statutes, was to substitute a philosophy of full disclosure for the philosophy of *caveat emptor* and thus to achieve a high standard of business ethics in the securities industry."[9] More recently, in *Superintendent of Insurance v. Bankers Life & Casualty Co.*,[10] the Supreme Court put the purpose of the Exchange Act on a much broader footing, indicating that Congress sought to remedy such problems as "disregard of trust relationships, . . . manipulation, investor's ignorance, and the like" through the passage of the Exchange Act.[11]

Rule 10b-5 has been of significant importance in helping the SEC work effectively to achieve these objectives. At the narrowest, the rule can be viewed as closing a loophole: 10b-5 provides protection against fraud perpetrated by buyers or sellers of securities, whereas previously, general antifraud relief under the securities laws was available only against the fraudulent practices of sellers.[12]

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[8] 375 U.S. 180 (1963).

[9] *Id.* at 186. *Accord*, SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 855 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969). *See* Shell v. Hensley, 430 F.2d 819, 826-27 (5th Cir. 1970); SEC v. Great Am. Indus., Inc., 407 F.2d 453, 462-63 (2d Cir. 1968) (Kaufman, J., concurring), *cert. denied*, 395 U.S. 920 (1969); 3 L. LOSS, SECURITIES REGULATION 1435 (2d ed. 1961); Recent Case, 82 HARV. L. REV. 938, 947 (1969).

[10] 404 U.S. 6 (1971).

[11] *Id.* at 11-12.

[12] Gilbert v. Nixon, 429 F.2d 348, 355 (10th Cir. 1970); SEC Securities and Exchange Act Release No. 3230 (May 21, 1942). The Securities Act of 1933, 15 U.S.C. §§ 77a-77aa (1970) [hereinafter cited as the Securities Act], contains several provisions that are aimed at fraudulent practices of sellers but none that are aimed at fraudulent practices of buyers. Section 12(2), 15 U.S.C. § 77*l*(2) (1970), expressly provides for civil liability for fraud in connection with an offer or sale of a security. Section 11(a), 15 U.S.C. § 77k(a) (1970), also provides civil remedies for purchasers of securities

At the broadest, 10b-5 can be viewed as a rule aimed at equalizing the bargaining positions of buyers and sellers, promoting full and accurate disclosure of facts necessary to ensure a more efficient allocation of resources, preventing investors with superior knowledge from victimizing uniformed investors,[13] and building public confidence in the fairness of securities transactions.[14]

If the SEC had the necessary manpower, these goals could perhaps be achieved through strict enforcement of rule 10b-5.[15] Furthermore, although SEC action may well prevent future injury, it does not compensate for past injuries.[16] By implying a private cause of action under 10b-5, the courts have been able to compensate the victims of fraud[17] and aid the SEC in achieving the overall policy goals of 10b-5.[18] The interaction between these policy considerations and the common law is particularly important as it gives direction to development of the private right of action under 10b-5.

B. *Common Law Fraud and Rule 10b-5*

Since the private right of action under 10b-5 was judicially de-

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if the fraud is in a registration statement. The implied private right of action, Globus v. Law Research Serv., Inc., 287 F. Supp. 188 (S.D.N.Y. 1968), *aff'd as to compensatory damages, rev'd as to punitive damages*, 418 F.2d 1276 (2d Cir. 1969), *cert. denied*, 397 U.S. 913 (1970); *contra*, Dyer v. Eastern Trust and Banking Co., 336 F. Supp. 890 (N.D. Maine 1971), and the express provisions for disciplinary action by the SEC under section 17(a), 15 U.S.C. § 77q(a) (1970), again are limited to fraud in connection with the offer or sale of any security. For a further discussion of the relationship between Securities Act § 17(a) and rule 10b-5, see notes 40-41 *infra*.

[13] Myzel v. Fields, 386 F.2d 718, 735-36 (8th Cir. 1967), *cert. denied*, 390 U.S. 951 (1968); Kohler v. Kohler Co., 319 F.2d 634, 642 (7th Cir. 1963); Brennan v. Midwestern Life Ins. Co., 259 F. Supp. 673, 681 (N.D. Ind. 1966), *aff'd*, 417 F.2d 147 (7th Cir. 1969), *cert. denied*, 397 U.S. 989 (1970).

[14] *See generally* 2 BROMBERG, *supra* note 4, §§ 12.2-.6.

[15] *See* Herpich v. Wallace, 430 F.2d 792, 804 (5th Cir. 1970).

[16] *Id.*, List v. Fashion Park, Inc., 340 F.2d 457, 463 (2d Cir.), *cert. denied*, 382 U.S. 811 (1965). Even a 10b-5 suit by the SEC to force a disgorging of illicit profits is primarily based on the deterrent effect of the remedy. SEC v. Manor Nursing Centers, Inc., 458 F.2d 1082, 1104 (2d Cir. 1972).

[17] Hecht v. Harris, Upham & Co., 430 F.2d 1202, 1206-07 (9th Cir. 1970); List v. Fashion Park, Inc., 340 F.2d 457, 463 (2d Cir.), *cert. denied*, 382 U.S. 811 (1965); 1 BROMBERG, *supra* note 4, § 2.4(1)(a).

[18] deHaas v. Empire Petroleum Co., 435 F.2d 1223, 1231 (10th Cir. 1970); Globus v. Law Research Serv., Inc., 418 F.2d 1276, 1284-85 (2d Cir. 1969), *cert. denied*, 397 U.S. 913 (1970); SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 854-55 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969); 1 BROMBERG, *supra* note 4, § 2.4(1)(d); Ruder, *Civil Liability Under Rule 10b-5: Judicial Revision of Legislative Intent*, 57 NW. U.L. REV. 627, 637 n.53 (1963). It is generally accepted that where the court does imply a private remedy under a statute "it is acting to further the general purpose which it finds in the legislation . . . ." RESTATEMENT (SECOND) OF TORTS § 286 comment *d* (1965). *But cf.* List v. Fashion Park, Inc., 340 F.2d 457, 463 (2d Cir.), *cert. denied*, 382 U.S. 811 (1965).

rived, few express statutory guidelines exist for identifying and defining its elements. The courts, therefore, have looked to common law and equitable fraud concepts in developing and applying the private 10b-5 action. That they should logically do so is apparent from the language of 10b-5 and the nature of the 10b-5 action. First, the words "fraud," "deceit," and "defraud" in subsections (a) and (c) of rule 10b-5 are words with established meanings, which can easily be read into private actions under the rule.[19] Second, since providing relief to victims of fraud is an important aspect of the private right of action under 10b-5, and since this is also the basic purpose of fraud actions at common law and at equity, the courts have naturally focused on the tort action of deceit and on the equitable action of rescission in structuring the elements of the 10b-5 action. This does not mean that courts "[froze common law fraud] elements for purposes of section 10(b) as they stood in 1934 nor [does it] forbid federal courts from taking part in the continuing growth of the common law of fraud and deceit,"[20] but it does mean that common law fraud provides a starting point from which the courts can develop a federal common law that will promote the broad policy goals of 10b-5.[21]

At common law the defrauded plaintiff had two alternative remedies available: one at law for the tort of deceit[22] or one at equity for rescission.[23] The elements of these common law fraud

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[19] *See* List v. Fashion Park, Inc., 340 F.2d 457, 463 (2d Cir.), *cert. denied*, 382 U.S. 811 (1965); Frankfurter, *Some Reflections on the Reading of Statutes*, 47 COLUM. L. REV. 527, 537 (1947); *Negligent Misrepresentations Under Rule 10b-5*, *supra* note 3, at 832. *Cf.* Note, *Regulation of Stock Market Manipulation*, 56 YALE L.J. 509, 511 (1947).

[20] Recent Case, 82 HARV. L. REV. 938, 947 (1969).

[21] *Negligent Misrepresentations Under Rule 10b-5*, *supra* note 3, at 832 n.36. *See The Supreme Court, 1971 Term*, 86 HARV. L. REV. 1, 270 (1972); *Civil Liability Under Section 10B and Rule 10B-5*, *supra* note 3, at 667.

Some courts have suggested that the elements of civil actions arising under 10b-5 are not limited to their common law definitions. Movielab, Inc. v. Berkey Photo, Inc., 321 F. Supp. 806, 810 n.2 (S.D.N.Y. 1970); Vanderboom v. Sexton, 294 F. Supp. 1178, 1192-93 (W.D. Ark. 1969), *rev'd on other grounds*, 422 F.2d 1233 (8th Cir.), *cert. denied*, 400 U.S. 852 (1970). In fact, the Supreme Court has recently suggested that a remedy may be available under 10b-5 even if no remedy is available under common law fraud. Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6, 12 (1971). Thus, in applying the elements of common law fraud to actions under 10b-5, the courts are well disposed to liberalize the elements of common law fraud, making them more favorable to the plaintiff.

[22] Deceit requires a misrepresentation of a material fact; scienter (*i.e.*, that the defendant knowingly made a false statement); justifiable reliance by the plaintiff, causing damage; and malice, if punitive damages are sought. PROSSER, *supra* note 6, §§ 105, 109, 110.

[23] "The elements of rescission . . . are 'misrepresentation' of a 'material' 'fact' on

actions have crept, in varying degrees, into civil actions based on 10b-5 violations.[24]

For the most part, the reliance element in 10b-5 cases assumes the same meaning it has in common law deceit actions.[25] The element of reliance operates to establish the causal connection between the defendant's fraud and the plaintiff's actions. Causation is the ultimate fact that must be proved, and reliance is the only acknowledged way to prove causation in misrepresentation cases.[26] As pointed out above, actual reliance requires both that one believe the misrepresentation to be accurate and that one enter into a securities transaction because of that belief. These dual requirements are generally subsumed under another common test which states that actual reliance is established if "the misrepresentation is a substantial factor in determining the course of conduct which results in [the defrauded plaintiff's] loss."[27] Normally, a misrepresentation cannot be a substantial factor in determining the plaintiff's course of conduct if he does not believe the misrepresentation.[28]

When viewed in the perspective of its objectives and in the perspective of common law, the implied private right of action under 10b-5 can be seen as an effort to apply the common law fraud concepts to securities regulation while moving beyond the restrictions of common law fraud where necessary to achieve the broad, remedial purposes of 10b-5. The reliance element, in particular, has been influenced by both the common law and the purposes of 10b-5. When it is required it takes the form of simple, actual reliance or, more than that, reasonable reliance, but in either event it assumes much the same meaning as it has at common law.

Both the decision to require some element of reliance and the characterization of the reliance requirement are, at common law and

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which the [plaintiff] 'justifiably relied.'" 3 LOSS, *supra* note 9, at 1627, 6 LOSS at 3784. Rescission can be granted if the fact is not material provided that the fraud produces the intended consequences. RESTATEMENT OF CONTRACTS § 476, comment *b* (1932).

[24] Mitchell v. Texas Gulf Sulphur Co., 446 F.2d 90, 97 (10th Cir.), *cert. denied*, 404 U.S. 1004 (1971). *See* note 21 *supra.*

[25] List v. Fashion Park, Inc., 340 F.2d 457, 462-63 (2d Cir.), *cert. denied*, 382 U.S. 811 (1965). When the 10b-5 action is for rescission, the same rule applies. *See* note 58 *infra* & accompanying text.

[26] *See* note 103 *infra* & accompanying text. This "transaction causation" must be distinguished from the causation of harm to the plaintiff or "damage causation." *See* notes 96-101 *infra* & accompanying text.

[27] RESTATEMENT OF TORTS § 546 (1938); Globus v. Law Research Serv., Inc., 287 F. Supp. 188, 194 (S.D.N.Y. 1968), *aff'd as to compensatory, rev'd as to punitive damages*, 418 F.2d 1276 (2d Cir. 1969), *cert. denied*, 397 U.S. 913 (1970).

[28] There is, however, an exception to this general rule. *See* note 104 *infra.*

under rule 10b-5, based on the nature of the fraud that gives rise to the plaintiff's injury and on the type of relief sought. The remainder of this Note will analyze the element of the reliance under 10b-5 in terms of three forms which the defendant's fraud may take.

III. MISREPRESENTATIONS KNOWN BY THE DEFENDANT TO BE FALSE OR MISLEADING

A. *The Reliance Requirement at Common Law*

Because the common law has been so influential in the development of the reliance concept under rule 10b-5, it is important to understand the reliance requirement in actions for deceit and rescission. In an equitable action for rescission, negligent reliance on the part of the plaintiff cannot shield the defendant, whether his misrepresentations are intentional or not.[29] It makes no difference that the plaintiff is foolish or ignorant,[30] or that the plaintiff fails to investigate the defendant's misrepresentations.[31] Actual,[32] justifiable[33] reliance is all that is required.

Deceit and rescission actions based on intentional misrepresentations are similar, to the extent that in neither does the plaintiff's reliance have to be reasonable. In an action for deceit, the plaintiff's reliance can be negligent and he is still not prevented from recovering.[34] This means that the plaintiff has no duty to investigate the defendant's statements before he can recover.[35] According to the American Law Institute (ALI), even if the plaintiff is on notice that the defendant's representations may be false there is no need to investigate. As in equitable rescission, justifiable reliance

[29] Given that a material fact is misrepresented, scienter, in itself, is unnecessary for recovery in recission actions. 3 J. POMEROY, EQUITY JURISPRUDENCE § 885 (1941); RESTATEMENT OF CONTRACTS § 476 comment *b* (1932). Likewise it appears as if the standard of reliance which is required for recovery is not tied to proof of scienter. *Cf.* RESTATEMENT OF CONTRACTS § 476, comments *c* & *d* A1932). A distinction, however, has been made between willful and innocent misrepresentations *of law* for purposes of reliance. Actual reliance is required if the misrepresentation is made with scienter but justifiable reliance is required for innocent misrepresentations. RESTATEMENT OF RESTITUTION § 55 (1937). For a discussion of the term "justifiable," see note 36 *infra.*

[30] RESTATEMENT OF CONTRACTS § 471, comment *i* (1932).

[31] RESTATEMENT OF CONTRACTS § 471, Illus. 3, 5 (1932); 12 S. WILLISTON, CONTRACTS § 1512 at 472 (3d ed. 1970).

[32] RESTATEMENT OF RESTITUTION § 9, comment *b* (1937).

[33] "Justifiable reliance" in equitable rescission has essentially the same meaning as in the tort action of deceit. *See* POMEROY, *supra* note 29, § 891. *See generally* note 36, *infra.*

[34] PROSSER, *supra* note 6, at 716.

[35] RESTATEMENT (SECOND) OF TORTS § 540 (Tent. Draft No. 10, 1964).

is all that is required.[36] The ALI rejected a proposal which would have denied recovery if the plaintiff knew or had reason to know of facts which made his reliance unreasonable. The primary objection voiced against this proposal was that it allowed contributory negligence to be a defense to an intentional tort.[37]

B. *Reliance Under Rule 10b-5*

Since the plaintiff's reliance need not be reasonable at common law when the defendant knows his representations are untrue, in light of the policy underlying 10b-5 the same standard should apply in private actions under the rule. In fact, most courts have held that in 10b-5 cases where the defendant's misrepresentations are intentional, the plaintiff's reliance need not be reasonable.[38]

Actual reliance was the standard adopted in *Globus v. Law Research Service, Inc.*[39] The plaintiff in *Globus* had brought an action under common law fraud, rule 10b-5, and section 17(a) of the Securities Act of 1933[40] alleging that he bought securities from the

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[36] RESTATEMENT OF TORTS § 537 (1938). Reasonable reliance imposes an affirmative duty upon the plaintiff to investigate the truth of the misrepresentations in certain cases before he can rely. Justifiable reliance imposes no such affirmative duty. Reliance is justified by the content of what is said or the person who said it. For example, the RESTATEMENT OF TORTS (1938) prevents reliance from being justified if the plaintiff knows it is false or its falsity is obvious (§ 541), or the matter is immaterial (§ 538). Further, reliance can be justified if the statement is based on facts which are peculiarly within the knowledge or under the power of the party making the misrepresentation. 3 POMEROY, *supra* note 29, § 891 at 506. In none of these cases is investigation required for the reliance to be justified; rather the justifiability of the reliance is determined at the moment the statement is made. It has been suggested that the acceptable justifications for reliance allowed under rule 10b-5 are less stringent than those allowed at common law. *See* Movielab, Inc. v. Berkey Photo, Inc., 321 F. Supp. 806, 810 n.2 (S.D.N.Y. 1970).

[37] 42 ALI PROCEEDINGS 322-31 (1965).

[38] Johns Hopkins Univ. v. Hutton, 326 F. Supp. 250 (D. Md. 1971); Lehigh Valley Trust Co. v. Central Nat'l Bank of Jacksonville, 409 F.2d 989 (5th Cir. 1969); Globus v. Law Research Serv., Inc., 287 F. Supp. 188 (S.D.N.Y. 1968), *aff'd as to compensatory damages, rev'd as to punitive damages*, 418 F.2d 1276 (2d Cir. 1969), *cert. denied*, 397 U.S. 913 (1970). *See* Janigan v. Taylor, 344 F.2d 781 (1st Cir.), *cert. denied*, 382 U.S. 879 (1965). *But see* Clement A. Evans & Co. v. McAlpine, 434 F.2d 100, 104 (5th Cir. 1970), *cert. denied*, 402 U.S. 988 (1971). This is not a new position and it has been recognized by several commentators. 2 BROMBERG, *supra* note 4, § 8.4 (120), (515); *Civil Liability Under Section 10B and Rule 10B-5*, *supra* note 3, at 677. *But see Reliance Under Rule 10b-5*, *supra* note 3.

[39] 287 F. Supp. 188 (S.D.N.Y. 1968), *aff'd as to compensatory damages, rev'd as to punitive damages*, 418 F.2d 1276 (2d Cir. 1969), *cert. denied*, 397 U.S. 913 (1970).

[40] 15 U.S.C. § 77q (1970) provides:

> (a) It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly —

defendant in reliance upon fraudulently misleading statements concerning the relationship between the defendant and Sperry Rand Corporation. The trial court had instructed the jury to award compensatory damages under section 17(a)[41] if they found that damage to the plaintiff resulted from statements which contained material facts known by the defendant to be false or misleading, provided that the plaintiff had actually relied on the statement.[42] The trial court also instructed the jury on punitive damages.[43] Following an adverse verdict, the defendants moved, *inter alia*, for judgment notwithstanding the verdict as to the award of punitive damages on the ground that "since the jury found for the defendants on the common law fraud claim, punitive damages could not be awarded against them."[44] In rejecting this argument, the court was careful to point out that actual reliance is the appropriate standard under the federal securities law and that such reliance need not even be justifiable:

> [Defendants' theory] would require that a plaintiff establish (1) justifiable reliance, necessary in a common law deceit action, *rather than the federal securities law fraud's actual reliance test*, i.e., that plaintiff would have been influenced to act differently than he did if the defendant had disclosed the omitted fact . . . .[45]

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(1) to employ any device, scheme, or artifice to defraud, or

(2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser. . . .

[41] Section 17(a), which applies only to defrauded buyers of securities, and rule 10b-5, which applies to both defrauded buyers and sellers of securities, are similar in several important respects. The language used in 10b-5 is derived from 17(a). SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 855 n.22 (2d Cir. 1968), *cert. denied*, 394 U.S. 978 (1969); 1 BROMBERG, *supra* note 4, § 2.2(410). The similarity is strengthened by the fact that both the section and the rule give rise to an implied private right of action. Globus v. Law Research Serv., Inc., 418 F.2d 1276, 1283-84 (2d Cir. 1969), *cert. denied*, 397 U.S. 913 (1970). Furthermore, many of the elements of the two actions are the same. Johns Hopkins Univ. v. Hutton, 326 F. Supp. 250, 254 (D. Md. 1971). *Compare* the approach taken by the district court in *Globus*, 287 F. Supp. at 197 (establishment of cause of action under 17(a) establishes cause of action under 10b-5) *with* that taken by the court of appeals, 418 F.2d at 1283-84 (establishment of 10b-5 action by defrauded buyer establishes action under 17(a)). Finally, the reliance requirement is identical under both. Johns Hopkins Univ. v. Hutton, 326 F. Supp. at 261.

[42] 287 F. Supp. at 194.

[43] *Id.*

[44] *Id.* at 195.

[45] *Id.* (emphasis added). Although the court of appeals reversed as to the award of punitive damages, it did so on policy and statutory grounds unrelated to the question of reliance.

Another 10b-5 case involving misrepresentations known by the defendant to be false is *Johns Hopkins University v. Hutton*,[46] in which Johns Hopkins sought to rescind its purchase of an oil and gas production payment. The court pointed out that although the defendant had not acted as an "evil man," he had knowledge of material facts that made his representations inaccurate and misleading. After noting that reliance is required under 10b-5, the court found that the undisputed facts were sufficient to show that reliance was present.[47] In discussing the reliance requirement, the court indicated that only actual reliance was required and that, even if there were no investigation, the plaintiff could still prove reliance on the intentionally misleading statements.[48] This suggests that where the plaintiff has actually relied, lack of investigation, which may make such reliance unreasonable, is not a sufficient basis upon which to deny recovery. The court noted, however, that even if the plaintiff's reliance must be reasonable, that is, even if it must have had a "right to rely," the plaintiff could still recover since it had acted as a reasonable man would have under similar circumstances.[49]

In *Lehigh Valley Trust Co. v. Central National Bank of Jacksonville*,[50] the defendant bank sold loan participation agreements to the plaintiff. In the course of negotiations preceding this sale, the defendant represented to the plaintiff that the guarantors of the loan in question were "high type individuals," "outstanding lawyers," and "outstanding citizens," and that the prime guarantor was a good customer of the defendant and was "all right."[51] In reality, however, the defendant had had difficulty collecting on previous notes of the prime guarantor; hence the statements were found to be intentionally false and actionable. The defendant argued that the plaintiff was a well-informed, knowledgeable investment institution and therefore should not be extended the protections applicable to unsophisticated investors. This argument was nothing more than a thinly veiled attempt to introduce the requirement of reasonable reliance into a case involving a misrepresentation known to be false by the defendant. The court rejected the argument out of hand: "Fraud may also be perpetrated upon the powerful and the sophisticated. . . . The protection and remedies of the Securities Act are

[46] 326 F. Supp. 250 (D. Md. 1971).

[47] *Id.* at 260.

[48] *Id.* at 257 & n.10.

[49] *Id.* at 258.

[50] 409 F.2d 989 (5th Cir. 1969).

[51] *Id.* at 992.

not accorded only to those who fail a battery of information and intelligence tests."[52] Thus, the actuality of the reliance and not its objective or subjective reasonableness was the appropriate issue in *Lehigh Valley*; reasonable reliance, objectively or subjectively measured, was properly rejected.

In *Globus*, *Johns Hopkins*, and *Lehigh Valley*, after finding that the defendants made knowingly false statements, the courts applied the common law rule that a plaintiff is not precluded from recovery if he negligently relies on a misrepresentation known by the defendant to be false. As these cases point out, the quality of the defendants' actions is a critical factor in determining the standard of reliance to which the plaintiff must conform. If the underlying rationale for rejecting a reasonable reliance standard in cases involving misrepresentations known to be false were articulated, it would no doubt center on the same reasons used for such a rejection in common law fraud: courts are understandably loathe to require a plaintiff to conform to the standard of a reasonable man if that allows a defendant to knowingly inflict injury, and to do so with impunity.

IV. NEGLIGENT MISREPRESENTATIONS

When the misrepresentation is negligently[53] rather than knowingly made, a much different situation is presented. With negligent misrepresentations, adequate justification exists for requiring that the plaintiff's reliance be reasonable before he can recover in a 10b-5 action.[54] Even here, however, confusion can be created in distinguishing between actual reliance, objectively reasonable reliance, and subjectively reasonable reliance.

In actions based on negligent misrepresentations the reliance requirements under 10b-5 and at common law are similar. In the

[52] *Id.*

[53] A misrepresentation is negligent if, ". . . considering all the circumstances, and particularly that of accessability to the facts, the defendant did not act as would the ordinarily prudent person to avoid misrepresentation . . . ." Note, *Proof of Scienter Necessary in a Private Suit Under SEC Anti-Fraud Rule 10b-5*, 63 MICH. L. REV. 1070, 1079 (1965).

[54] A plaintiff has reasonably relied if he has actually relied and if his belief in the accuracy of the defendant's representations was reasonable.

One writer has suggested that courts have required that the plaintiff's reliance be reasonable in all cases before recovery can be obtained under 10b-5. *Reliance Under Rule 10b-5*, *supra* note 3, at 565-66. However, by failing to distinguish negligent misrepresentations both from misrepresentations known to be false and from pure omissions, this theory of reasonable reliance is more restrictive than common law fraud, *see* notes 29-37 *supra* & accompanying text, and therefore, is inconsistent with the liberal policy bases of rule 10b-5. *See* notes 8-18 *infra* & accompanying text.

equitable action of recission a plaintiff will be barred from recovery if his reliance is unjustified.[55] In tort actions of deceit, on the other hand, where there is very little case law on this issue,[56] the ALI has decided that "the recipient of a negligent misrepresentation is barred from recovery for a pecuniary loss suffered in reliance upon it if he is negligent in so relying."[57]

The courts have generally adopted the same position in 10b-5 actions as the ALI adopted in deceit actions and have found that the plaintiff's reliance must be reasonable when the defendant's misrepresentations are negligent.[58] In *City National Bank v. Vanderboom*,[59] the defendant-investors had obtained a loan from City National to buy securities in various corporations. When they failed to pay back the loan, the bank filed suit. Vanderboom counterclaimed under 10b-5, alleging that the bank had falsely represented the financial status of the corporations whose stock they had purchased with the proceeds of the loan. The trial court found that the bank did not have knowledge of the alleged fraud perpetrated by one of its officers, that knowledge of the alleged fraud could not be imputed to the bank, that the bank acted in good faith, and that the bank merely loaned money to the investors and did not sell or offer to sell any securities.[60] The court of appeals affirmed the district court's holding that 10b-5 did not apply because the transaction counterclaimed upon was not "in connection with the purchase or sale of any security," and that, therefore, the purchaser-seller standing requirement of the rule was not satisfied.[61]

The discussion of the investors' reliance upon the allegedly negligent misrepresentations by the bank, albeit dicta, is nonetheless instructive. The Eighth Circuit, after setting forth reasonable

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[55] *See* notes 29-33 *supra* & accompanying text.

[56] 42 ALI PROCEEDINGS 394 (1965).

[57] RESTATEMENT (SECOND) OF TORTS § 552A (Tent. Draft No. 11, 1965).

[58] This is also the position taken by most commentators who have considered this question. *Negligent Misrepresentations Under Rule 10b-5, supra* note 3, at 841; *Civil Liability Under Section 10B and Rule 10B-5, supra* note 3, at 673. However, there are isolated instances where courts have refused to require reasonable reliance in such situations. *See* Myzel v. Fields, 386 F.2d 718 (8th Cir. 1967), *cert. denied*, 390 U.S. 951 (1968).

Arguably the relief requested should be a factor in determining the reliance standard. This would necessitate adoption of a justifiable reliance standard where rescission is sought, *see* note 55 *supra* & accompanying text, and a reasonable reliance standard where damages are sought. Such an approach would retain consistency between the private action under 10b-5 and the ancestral actions of deceit and rescission.

[59] 422 F.2d 221 (8th Cir.), *cert. denied*, 399 U.S. 905 (1970).

[60] 422 F.2d at 227.

[61] *Id.* at 228.

reliance as the requisite standard,[62] found the investors' reliance to be negligent.[63] Although the reasonable reliance standard used in *Vanderboom* was intended to be an objective standard,[64] the court noted that because of the defendant-investors' ready access to the information involved, they were expected to adhere to a higher degree of care in relying than investors lacking such access to relevant information.[65] This introduces a subjective standard of reasonableness — one that takes into account changes in the requisite standard of care based on facts peculiar to the individual plaintiff's situation — rather than an objective standard.[66]

Under the reasonable reliance requirement both subjective and objective standards have been used to measure the reasonableness of the reliance. The blurring of the distinction between the subjective and the objective standards in *Vanderboom* should not obscure the fact that the two standards have been used in different situations by the courts.[67] It should also not obscure the fact that the use of sub-

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[62] With regard to misrepresentations, the question is whether a reasonable investor, in light of the facts existing at the time of the misrepresentation and in the exercise of due care, would have been entitled to rely upon the misrepresentation. . . .

It should be noted from the outset that this "reasonable investor" test is an objective standard. Whether an investor did in fact rely upon a misrepresentation is immaterial for the purpose of determining statutory coverage, though reliance is a predicate for recovery once coverage is established.

Id. at 230-31. That this test applies to negligent misrepresentations is clear not only from the fact that this was the situation facing the court, but also from a footnote to its opinion where the court agreed with a commentator who had "suggested that reasonable reliance should be a condition to all private actions based on negligent misrepresentations under 10b-5" and noted that its test reflected this standard. *Id.* at 230 n.11.

[63] *Id.* at 231.

[64] *Id.* at 230.

[65] *Id.* at 231.

[66] Actually, subjective and objective reasonableness differ only in degree. When the term "investor" is substituted for "man" in the reasonable man test, the test begins to reflect facts peculiar to the individual plaintiff but it is still an objective standard. As the test is increasingly modified by more qualities of the individual plaintiff whose reliance is being evaluated, however, it becomes an increasingly subjective standard. *See* Seavey, *Negligence — Subjective or Objective?*, 41 HARV. L. REV. 1, 4 (1927). Such a subjective standard of care would consider such factors as the plantiff's general business experience and expertise; his acquaintance with the affairs of the corporation; his access to information misrepresented; the existence of a fiduciary relationship; and, whether he initiated the transaction. *See Reliance Under Rule 10b-5, supra* note 3.

[67] Cases which require subjective reasonableness can be distinguished from those requiring objective reasonableness on the basis of the nature of the transaction giving rise to the alleged injury. In indirect, impersonal securities transactions, such as those over a stock exchange, the subjective reasonableness of reliance is difficult to prove. Thus, in such cases the applicable standard should be objective. In face-to-face transactions, however, where subjective reasonableness is susceptible of proof, the courts tend to hold plaintiffs to such a standard. *Reliance Under Rule 10b-5, supra* note 3, at 576-77.

jective factors by a court does not necessarily mean that it has adopted the reasonable reliance standard, since actual reliance is also based on subjective factors.[68]

Subjective factors were used in *Myzel v. Fields*,[69] although the court rejected the reasonable reliance standard. The plaintiffs, four shareholders in a small corporation in which the individual defendants were also shareholders, sold their shares to the defendants because of gloomy statements made by the defendants about the corporation's financial position. The trial court held the defendants liable on the basis of jury findings that the defendants knew the misrepresentations were false, and that the plaintiffs had actually relied upon them. The Eighth Circuit affirmed, noting that since the defendants need only be negligent to satisfy the 10b-5 scienter requirement, they were not prejudiced by the district court's jury instruction that they had to be "found conscious wrongdoers before liability ensued."[70] The court of appeals then went on to hold that there was sufficient evidence to support the jury's finding that the plaintiffs had actually relied.[71] Three plaintiffs were found to have relied since they were unfamiliar with the business and had to place their total trust in the defendants.[72] Because the fourth plaintiff, who was more familiar with the business, failed to investigate, the appellate court found him to be "if anything . . . grossly negligent."[73] However, the Eighth Circuit acknowledged that the jury could properly find "naked reliance *in this particular case.*"[74] Thus even though the fourth plaintiff was found to have been unreasonable, he was still allowed recovery because he actually relied. Rea-

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[68] *See* note 76 *infra*. A basic distinction in the use of subjective factors in the context of reasonable reliance, as opposed to actual reliance, is that insofar as actual reliance is concerned, subjective factors are used to establish the actuality of the particular plaintiff's reliance. On the other hand, in the context of reasonable reliance, when subjective factors are used it is to establish the standard of care to which the plaintiff must have conformed: the subjective reasonableness of the particular plaintiff's reliance is immaterial, the relevant inquiry being whether the reasonable investor in the plaintiff's circumstances would have relied.

[69] 386 F.2d 718 (8th Cir. 1967), *cert. denied*, 390 U.S. 951 (1968).

[70] 386 F.2d at 734-35. Although it appears that the court of appeals held the defendants to a negligence standard, its agreement with the district court's use of an actual, rather than reasonable, reliance standard, *see* notes 71-74 *infra* & accompanying text, may indicate that the appellate court's analysis was tied to the jury's finding of a knowing misrepresentation.

[71] *Id.* at 735-36.

[72] *Id.*

[73] *Id.* at 736.

[74] *Id.* at 737.

sonable reliance was thereby rejected and actual reliance was affirmed as the standard for recovery.

Myzel points out that the use of subjective factors does not indicate the court had adopted the reasonable reliance standard.[75] Under certain circumstances, subjective factors are indispensable in determining the reasonableness of the reliance, but this is not their sole function. In *Myzel* the court used subjective factors in applying an actual reliance test.[76] Indeed, the only way actual reliance can be established is to look at such factors as would focus on the individual plaintiff and determine whether, in light of the plaintiff's particular idiosyncracies and the circumstances surrounding the transaction, it is probable that he actually relied, that is, that the fraud played a substantial role in his decision-making process. This is not to say that there is no relationship whatsoever between actual reliance and reasonable reliance. The absence of reasonableness may well be a factor in determining the credibility of the plaintiff's allegation that he actually relied. But where only actual reliance is required, the lack of reasonable reliance will not preclude a plaintiff from recovery if actual reliance can otherwise be shown.

As opposed to *Myzel*, *Mitchell v. Texas Gulf Sulphur Co.*[77] does not deviate from the common law rule that the plaintiff's reliance must be reasonable when the defendant's conduct is merely negligent. Texas Gulf Sulphur Co. (TGS), by April 12, 1964, had sufficient facts to compel a conclusion that they had just discovered an enormous mineral deposit on lands to which they owned mineral rights. In response to rumors started by a news leak of the discovery, TGS issued a press release on April 12 denying knowledge of the extent and great value of the discovery. On April 16, another press release was issued detailing the extent of the discovery.

After agreeing with the district court that the April 12 press release was materially misleading,[78] the Tenth Circuit concluded that the press release had been negligently issued by TGS.[79] The court

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[75] *But see Reliance Under Rule 10b-5*, *supra* note 3, at 571 & n.56.

[76] "[T]he question of actual reliance is a subjective one. Myzel v. Fields, *supra*, 386 F.2 at 737." Lane v. Midwest Bancshares Corp., 337 F. Supp. 1200, 1208 (E. D. Ark. 1972).

[77] 446 F.2d 90 (10th Cir.), *cert. denied*, 404 U.S. 1004 (1971).

[78] 446 F.2d at 97.

[79] Although the district court found that the press release was " 'intentionally deceptive . . . and knowingly deficient in material facts,' " the court of appeals noted only that it could not "conclude that TGS sustained its burden of proving that it did not know of the misrepresentation, nor was it demonstrated that with due diligence TGS could not have known of the faultiness of the statement." *Id.* at 102.

of appeals then scrutinized the district court's finding that "each of the [plaintiffs] herein relied on [the April 12 press release] in making his decision to sell his TGS stock, and that none knew of the announcement of April 16 at the time of his sale."[80] Although agreeing that the evidence demonstrated that the misleading release was a substantial factor in each plaintiff's decision to sell, and that they had, therefore, actually relied,[81] the court of appeals denied recovery to those plaintiffs whose reliance was unreasonable.

> At some point in time after the publication of a curative statement such as that of April 16, stockholders should no longer be able to claim reliance on the deceptive release, sell, and then sue for damages when the stock value continues to rise. This is but a requirement that stockholders too act in good faith and with due diligence in purchasing and selling stock. . . .
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> . . . We conclude that by Wednesday, April 22 . . . the reasonable investor would have become informed of the April 16 release and could no longer rely on the earlier release in selling TGS stock.[82]

Mitchell, therefore, clearly points out the distinction between actual and reasonable reliance. Where reliance is required, in order for the plaintiff to recover there must always be, at a minimum, actual reliance. When the circumstances call for reasonable reliance standards, the plaintiff must demonstrate that, in addition to actually believing the accuracy of the misrepresentation, his belief was reasonable in light of the facts which he knew or should have known at the time he relied.

The adoption of the reasonable reliance standard in cases such as *Mitchell* and *Vanderboom* probably stems from an analogy to contributory negligence. Just as the defendant is not held liable for his own negligence if the plaintiff is contributorily negligent, a defendant should not be held liable for a negligent misrepresentation if the plaintiff would not have been injured had he not negligently relied on the misrepresentation.[83] Therefore, where reliance is required, the proper approach is to tie the standard of reliance which the plaintiff must meet to the level of scienter which has been proven. If the plaintiff can prove that the defendant made the misrepresentation with knowledge of its falsity, then the plaintiff need

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[80] *Id.*

[81] *Id.* at 103.

[82] *Id.*

[83] It should be pointed out that reasonable reliance is different from contributory negligence in that it is an element of the cause of action where it is required, whereas contributory negligence is an affirmative defense.

only prove that he actually relied. On the other hand, if the plaintiff can only show that the defendant was negligent in making the misrepresentation, then the plantiff must prove also that his reliance was reasonable.

Not all courts, however, have adopted the reasonable reliance requirement in cases of negligent misrepresentation. Notable among these cases is *Myzel v. Fields*.[84] Cases such as *Myzel* are consistent with the language used by the Supreme Court in *Superintendent of Insurance v. Bankers Life & Casualty Co.*[85] which suggested that the remedies provided by 10b-5 may not be limited by common law fraud. Such cases are also in accord with the current sentiment disfavoring the defense of contributory negligence because of its often harsh and unjust results.[86]

V. PURE OMISSIONS

A. *Absence of Necessity for Reliance*

Situations in which a defendant is liable under rule 10b-5 for a total failure to disclose material information as to which there was a duty to disclose are quite different, insofar as reliance is concerned, from situations involving affirmative misrepresentations. The basic difference stems from the fact that "reliance on the *nondisclosure* of a fact is a particularly difficult matter to define or prove."[87] Since reliance requires a belief in the truth of the fact represented,[88] and since no fact is represented by silence,[89] reliance is virtually impossible to prove in cases involving pure omissions. Furthermore, were proof of reliance required in such cases, two of the basic purposes of allowing private recovery under rule 10b-5 — aiding the SEC in achieving the broad policy goals of the rule[90] and compensating the victims of fraud through modification of the doctrine of *caveat emptor*[91] — would be frustrated.[92] Therefore, in cases in-

[84] 386 F.2d 718 (8th Cir. 1967), *cert. denied*, 390 U.S. 951 (1968).

[85] 404 U.S. 6, 12 (1971).

[86] *See* PROSSER, *supra* note 6, at 418.

[87] Mills v. Electric Auto-Lite Co., 396 U.S. 375, 382 n.5 (1970). *See* 2 BROMBERG, *supra* note 4, § 8.6, at 209.

[88] *See* note 6, *supra* & accompanying text.

[89] List v. Fashion Park, Inc., 340 F.2d 457, 463 (2d Cir.), *cert. denied*, 382 U.S. 811 (1965), implicitly rejected the notion that by maintaining silence the defendant was representing the negative of the matter concealed from the plaintiff when it stated that the plaintiff need not show active reliance on the defendant's silence. *See* 2 BROMBERG, *supra* note 4, § 8.6, at 209.

[90] *See* note 18 *supra* & accompanying text.

[91] *See* note 17 *supra* & accompanying text.

[92] Because of the difficulty of proving reliance in cases of pure omissions, recovery

volving pure omissions, "positive proof of reliance is not a prerequisite to recovery."[93]

B. *The Relationships Among Reliance, Materiality, and Causation*

To avoid frustrating the purposes of the implied private action under rule 10b-5 in pure omission cases, the courts have modified the alignment of reliance, materiality, and causation. Traditionally, reliance operates to prove causation.[94] In nondisclosure cases, however, causation is presumed by proof of materiality, making proof of reliance unnecessary.[95]

1. *Reliance and Causation.*— Causation is usually required twice in actions based on fraud under either the common law action of deceit or under 10b-5.[96] First there must be "transaction causation," also known as "reliance causation." Under 10b-5 this means that the misrepresentations or omissions must cause the plaintiff to buy or sell securities; under common law deceit, to embark on any course of conduct.[97] The transaction causation requirement is satis-

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would be denied in most instances if reliance were required. Obviously the more often attempted 10b-5 recovery is frustrated by problems of proof, the less motivation there is for prospective defendants to conform their conduct to the standard set forth by 10b-5. *See* List v. Fashion Park, Inc., 340 F.2d 457, 463 (2d Cir.), *cert. denied*, 382 U.S. 811 (1965).

[93] Affiliated Ute Citizens v. United States, 406 U.S. 128, 153 (1972). *See* Painter, *supra* note 3, at 1370-71; *SEC Rule 10b-5: A Recent Profile*, *supra* note 3, at 886-88; *Civil Liability Under Section 10B and Rule 10B-5*, *supra* note 3, at 672-73. *But see* Financial Indus. Fund, Inc. v. McDonnell Douglas Corp., CCH FED. SEC. L. REP. ¶ 93,773, at 93,376 (10th Cir. 1973).

[94] *See* note 26 *supra* & accompanying text.

[95] Affiliated Ute Citizens v. United States, 406 U.S. 128, 153 (1972); Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., CCH FED. SEC. L. REP. ¶ 93,714, at 93,168 (S.D.N.Y. 1972). The Court in *Affiliated Ute* did not indicate whether or not this presumption is rebuttable and, if so, what is necessary to rebut it. Arguably it should be rebuttable. 2 BROMBERG, *supra* note 4, § 8.6(2), at 212.

[96] 2 BROMBERG, *supra* note 4, § 8.7(1), at 216. *See* RESTATEMENT OF TORTS § 546 (1938). *See generally* Recent Case, 21 CASE W. RES. L. REV. 787 (1970).

[97] Transaction causation is considered by some courts to be an element of 10b-5 because the rule provides that the fraud must be "*in connection with* the purchase or sale of any security" (emphasis added). City Nat'l Bank v. Vanderboom, 422 F.2d 221, 230 (8th Cir.), *cert. denied*, 399 U.S. 905 (1970); Heit v. Weitzen, 402 F.2d 909, 913 (2d Cir. 1968), *cert. denied*, 395 U.S. 903 (1969); SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 860 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969). Other courts require transaction causation because it is essential to common law fraud. At common law, if the plaintiff "was not in any way influenced by [the misrepresentation or omission], and would have done the same thing without it for other reasons, his loss is not attributed to the defendant." PROSSER, *supra* note 6, at 714.

An exception to the transaction causation notion is the case where the plaintiff need not enter into a transaction in order for the fraud to be successful as to him. Crane Co. v. Westinghouse Air Brake, 419 F.2d 787 (2d Cir. 1969); Vine v. Beneficial Fin. Co.,

fied by a showing of causation-in-fact.[98] Causation-in-fact has been defined as the relationship existing between the defendant's conduct and the actions of the plaintiff when the defendant's conduct is a material element and a substantial factor in bringing about the plaintiff's actions.[99]

Second, there must be "damage causation." That is, the plaintiff's actions, which were induced by the defendant, must cause him to suffer an economic loss.[100] The damage causation requirement is satisfied by a showing of proximate cause.[101] Viewed together, transaction causation and damage causation require that the defendant's misrepresentations must have been the cause of the plaintiff's damage.

As has been pointed out, the reliance requirement is a causation requirement. Once reliance is established, causation-in-fact is also established because reliance requires that the plaintiff act or refrain from acting because of his belief in the truth of the defendant's representations. While this does not require that the defendant's representation be the *sine qua non* of the plaintiff's action or non-

374 F.2d 627 (2d Cir.), *cert. denied*, 389 U.S. 970 (1967); Voege v. American Sumatra Tobacco Corp., 241 F. Supp. 369 (D. Del. 1965). In *Crane*, for example, the plaintiff made a tender offer of fifty dollars per share to Air Brake stockholders for Air Brake stock. Air Brake resisted this take-over attempt and enlisted the help of American Standard, which bought significant quantities of Air Brake stock and artificially raised the market price to fifty dollars per share thereby defeating the plaintiff's tender offer. In this case, transaction causation, or reliance by the plaintiff, could not logically be an element of the plaintiff's cause of action because the fraud was such that it could be successful whether or not it caused the plaintiff to enter into any transaction. In such cases, however, damage causation is still required.

[98] Chasins v. Smith, Barney & Co., Inc., 438 F.2d 1167, 1172 (2d Cir. 1971).

[99] PROSSER, *supra* note 6, at 240. "The test is one of significance rather than largeness or smallness, or quantum." *Id.* at 240 n.29. The ALI, on the other hand, finds causation-in-fact to exist when the defendant's conduct has *any effect* in bringing about the plaintiff's actions. RESTATEMENT (SECOND) OF TORTS § 431 comment *b* (Tent. Draft No. 10, 1964).

[100] RESTATEMENT OF TORTS § 546 (1938). The damage causation requirement in 10b-5 cases is a carryover from the common law. Certification that the conduct of the defendant actually caused the plaintiff's injury is a basic element of tort law. Crane Co. v. Westinghouse Air Brake, 419 F.2d 787, 797 (2d Cir. 1969).

[101] Smith v. Bear, 237 F.2d 79, 87-88 (2d Cir. 1956); 1 HARPER & JAMES, *supra* note 6, at 583; RESTATEMENT (SECOND) OF TORTS § 548A (Tent. Draft No. 11, 1965). In order for a proximate or legal cause to exist there must first be a cause-in-fact. The case law has left open the question of whether the proximate cause relationship existing between the defendant's conduct and the plaintiff's injury requires a concept of causation-in-fact separate from that required to show transaction causation. Harper and James appear to believe that once causation-in-fact has been established for purposes of transaction causation it has been established for purposes of damage causation as well. 1 HARPER & JAMES, *supra* note 6, § 7.13 at 584. While it is not clear, Prosser may also accept this position. *See* note 97 *supra*. Of course, once causation-in-fact is established for purposes of damage causation, there still must be a finding that the cause-in-fact was the legal or proximate cause as well.

action, it does require that it be a cause-in-fact.[102] In cases involving affirmative misrepresentations, since proof of reliance is normally the only method recognized by the courts to prove transaction causation,[103] the two concepts are largely coterminous.[104] Proof of reliance is not the only way causation can be established, however, and in pure omission cases where there is no statement to rely upon, or where it is otherwise impossible to prove reliance, the courts have allowed causation to be presumed upon proof of the materiality of the fact not disclosed.

2. *Materiality and Causation.*— The use of materiality to presume causation first received acceptance by the Supreme Court in *Mills v. Electric Auto-Lite Co.*,[105] which arose under SEC rule 14a-9.[106] *Mills* was an action by shareholders seeking to set aside a merger accomplished through the use of a proxy statement that was misleading because it failed to adequately disclose material facts.[107]

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[102] *See* note 113 *infra.*

[103] List v. Fashion Park, Inc., 340 F.2d 457, 463 (2d Cir.), *cert. denied*, 382 U.S. 811 (1965), which involved misrepresentations as well as nondisclosures, suggested that to abandon proof of reliance would be to abandon proof of causation-in-fact.

[104] However, reliance and transaction causation are not synonomous, since transaction causation can exist independently of reliance. Suppose for example the plaintiff is holding shares of defendant corporation. Defendant makes misrepresentations as to the financial position of the corporation which the plaintiff does not believe but thinks other shareholders may believe. If other shareholders do believe them, they would sell their shares and the market value of the plaintiff's shares would fall. Plaintiff therefore decides to sell and does so within a reasonable time after the defendant makes the misrepresentation, but not before he sustains a loss on the artifically depressed market. In this situation the plaintiff could not have relied because he did not believe the misrepresentations. However, the defendant's misrepresentations were the cause-in-fact of the plaintiff's decision to sell his shares. *See Civil Liability Under Section 10B and Rule 10B-5*, *supra* note 3, at 672.

[105] 396 U.S. 375 (1970), *rev'g*, 403 F.2d 429 (7th Cir. 1968). *See generally* Recent Case, 21 CASE W. RES. L. REV. 787 (1970).

[106] 17 C.F.R. § 240.14a-9. This rule is the anti-fraud provision applicable to proxy statements. It provides:

> (a) No solicitation subject to this regulation shall be made by means of any proxy statement, form of proxy, notice of meeting or other communication, written or oral, containing any statement which, at the time and in the light of the circumstances under which it is made, is false or misleading with respect to any material fact, or which omits to state any material fact necessary in order to make the statements therein not false or misleading or necessary to correct any statement in any earlier communication with respect to the solicitation of a proxy for the same meeting or subject matter which has become false or misleading.

[107] The merger involved was between Autolite and Mergenthaler Linotype Co., which owned 54 percent of Autolite prior to the merger. Liability was based on inadequate disclosure of the relationship of the members of the Autolite board of directors, which endorsed the merger, to Mergenthaler. Although the court of appeals found that the proxy statement contained information which indicated the relationship, it found also that the endorsement was in heavier type than information concerning the relationship and that the proxy statement implied that the Autolite board's endorsement

The major issue was whether there was a causal connection between the nondisclosure and the merger. The Seventh Circuit shifted the burden of proof to the defendant, and held that the defendant could disprove causation by proof of the fairness of the merger. If the merger was fair the court could assume that it would probably have been approved even had there been no omission of a material fact. The Supreme Court implied that this presumption of lack of causation would have to be rebutted by proof of reliance.[108] However, the plaintiffs could not be expected to prove reliance in this situation, not only because of the many plaintiffs involved, but also because it involved a cause of action which was based on a nondisclosure.[109] The Court noted a further problem with the standard applied by the Seventh Circuit: there was no reason to believe that the shareholders would have approved the merger had it been fair.[110]

After rejecting the standard set down by the Seventh Circuit, the Supreme Court focused on the question of whether materiality would be sufficient to prove the causal connection. Justice Harlan, writing for the majority, cited several definitions of materiality. One used frequently appears in the RESTATEMENT (SECOND) OF TORTS: A fact is material if "its existence or nonexistence is a matter to which a reasonable man would attach importance in determining his choice of action in the transaction in question."[111] Accord-

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was independently made. Mills v. Electric Autolite Co., 403 F.2d 429, 432-35 (7th Cir. 1968). The Court, therefore, concluded that:

> As a matter of law the proxy statement failed, in connection with the advice tendered by the board, adequately to bring out the relationship between the board members and Mergenthaler. This, in terms of [rule 14a-9], was an omission of a material fact necessary in order to make the statements therein not misleading.

Id. at 435. With respect to transaction causation or reliance, the fact that *Mills* involved a half-truth rather than a pure omission should not be important. *See* notes 122 & 123 *infra* & accompanying text. In both cases liability is predicated upon material facts which are not disclosed, and which arguably cannot be relied upon. *See* notes 88-89 *supra* & accompanying text. Furthermore, if reliance is not necessary in half-truth cases, *see* notes 122, 123 *infra* & accompanying text, a fortiori it is not necessary in pure omission cases.

[108] 396 U.S. at 382 n.5.

[109] *Id.*

[110] *Id.*

[111] RESTATEMENT (SECOND) OF TORTS § 538(2)(a) (Tent. Draft No. 10, 1964). *Accord* 6 LOSS, *supra* note 9, at 3534. Materiality has been limited by the SEC to ". . . those matters as to which an average prudent investor ought reasonably to be informed before buying or selling the security registered." 17 C.F.R. § 240.12b-2(j). *See* 17 C.F.R. § 230.405(*l*). Both this statement and the one used in the RESTATEMENT (SECOND) OF TORTS appear to cover the same ground. *See* Johns Hopkins University v. Hutton, 422 F.2d 1124, 1128-29 (4th Cir. 1970). However, the Restatement definition appears to be the one used most frequently by courts in 10b-5 actions. Rogen v. Ilikon

ing to Justice Harlan, this definition "embodies a conclusion that the defect was of such a character that it was considered important by a reasonable shareholder. . . ."[112] and thus the finding of materiality is sufficient to show the causal relationship between the violation and the injury.[113]

The reasoning applied in *Mills*, although directly applicable to actions under rule 14a-9, has received indirect judicial recognition as being applicable to actions arising under 10b-5.[114] Other cases have recognized that the reliance requirement in 10b-5 omissions cases is not essential, but that causation-in-fact is the relevant inquiry.[115]

Corp., 361 F.2d 260, 266 (1st Cir. 1966); List v. Fashion Park, Inc., 340 F.2d 457, 462 (2d Cir.), *cert. denied*, 382 U.S. 811 (1965).

The Restatement definition requires that the reasonable man *would* be affected by the misrepresentation. There is a trend toward reducing the degree of probability that a reasonable man be affected in order for a fact to be material. *See SEC Rule 10b-5: A Recent Profile*, *supra* note 3, at 883-84. Some courts have required only that the reasonable man *might* have been affected, Affiliated Ute Citizens v. United States, 406 U.S. 128, 154 (1972); SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 849 (2d Cir. 1968), *cert. denied*, 394 U.S. 978 (1969); or that he *might well* have been affected, Chasins v. Smith, Barney & Co., 438 F.2d 1167, 1171 (2d Cir. 1970); or that he *could* have been affected, *In re* Investors Management Co., SEC Securities and Exchange Act Release No. 9267 (July 29, 1971), [1970-1971 Transfer Binder] CCH FED. SEC. L. REP. ¶ 78,163, at 80,519 (SEC 1971). *See generally* Feit v. Leasco Data Processing Equip. Corp., 332 F. Supp. 544, 569-75 (E.D.N.Y. 1971); Recent Case, 21 CASE W. RES. L. REV. 787, 794-95 (1970).

In addition, courts have differed in delineating how the reasonable man must be affected for a fact to be material. The Restatement requires that he would *attach importance* to the fact. *Accord* Affiliated Ute Citizens v. United States, 406 U.S. 128, 154 (1972). Other courts have phrased this requirement in terms of "*affect[ing] the desire* of investors to buy, sell, or hold . . . securities," SEC v. Texas Gulf Sulphur Co., 401 F.2d at 849 (emphasis added), *acting otherwise* than they did, Chasins v. Smith, Barney & Co., 438 F.2d at 1171, or *influencing their decision*, *id.* at 1172. The test which arises from these two decisions is that something is material if the reasonable investor might have considered it important in the making of his decision. Affiliated Ute Citizens v. United States, 406 U.S. at 154. The Supreme Court decisions in *Mills* and *Affiliated Ute* should eliminate this multiplicity of standards. *But see* Chris-Craft Indus., Inc. v. Bangor Punta Corp., CCH FED. SEC. L. REP. ¶ 93,816 at 93,505 (2d Cir. March 16, 1973). Note that the test for materiality, however defined, is an objective one. Rogen v. Ilikon Corp., 361 F.2d 260, 266 (1st Cir. 1966).

[112] 396 U.S. at 384.

[113] *Id.* at 385. The Court noted that given the materiality of the defect the causal relationship does not require proof of whether the defect *actually* had a decisive effect on the voting, but instead, whether the proxy solicitation containing the defect as opposed to the defect itself was an essential link in the accomplishment of the transaction. *Id.* at 384-85. This *sine qua non* test (that the defect must have a decisive effect on the voting) has been repeatedly discredited as being too favorable to the defendant. *E.g.*, Hill York Corp. v. American Int'l. Franchises, 448 F.2d 680, 696 (5th Cir. 1971); Gilbert v. Nixon, 429 F.2d 348, 357 (10th Cir. 1970).

[114] Kohn v. American Metal Climax, Inc., 458 F.2d 255, 269 (3d Cir. 1972); Kahan v. Rosensteil, 424 F.2d 161, 173-74 (3d Cir. 1970), *cert. denied*, 393 U.S. 1026 (1970).

[115] *See, e.g.*, Chasins v. Smith, Barney & Co., Inc., 438 F.2d 1167, 1172 (2d Cir. 1970).

A direct application of the reasoning in *Mills* to a 10b-5 case did not come, however, until *Affiliated Ute Citizens v. United States*.[116] The plaintiffs had sold shares of Affiliated Ute Citizens through employees of the defendant bank[117] at a price significantly below the market value, the difference being pocketed by the bank's employees. The Supreme Court found that the case involved primarily a failure of the employees to disclose the fact that they "were in a position to gain financially from [the plaintiffs'] sales and that [the plaintiffs'] shares were selling for a higher price in that market."[118] On these findings the Court held that positive proof of reliance is not a prerequisite to recovery:[119] All that is necessary to establish the requisite element of causation-in-fact is an obligation to disclose and the withholding of a material fact.[120] Not only did *Affiliated Ute* follow *Mills* in holding that materiality proves causation,[121] but it went one step further and directly held that reliance is not necessary in cases based on nondisclosures.

Arguably, this holding could apply to half-truths as well. The facts of *Affiliated Ute* show that several of the violations of rule 10b-5 were half-truths since some of the plaintiffs were told that the price offered was all that could be given by the bank employees[122]

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[116] 406 U.S. 128 (1972), *aff'g in part, rev'g in part* Reyos v. United States, 421 F.2d 1337 (10th Cir. 1970). *See, The Supreme Court, 1971 Term, supra* note 21, at 268-72.

[117] The employees bought 8-1/3 percent of the plaintiffs' shares for their personal portfolios without disclosing that fact to the sellers.

[118] 406 U.S. at 153.

[119] *Id.*

[120] *Id.* at 153-54.

[121] *Mills* is open to two possible interpretations: first, the Supreme Court merely agreed with the decision of the appellate court to shift to the defendant the burden of proving lack of reliance; or, second, the Supreme Court dispensed with proof of reliance, allowing the causation element to be established upon proof of materiality. Recent Case, 21 CASE W. RES. L. REV. 787, 790 & n.11. *Affiliated Ute* seems to be recognizing the latter interpretation of *Mills* as the proper one.

[122] The Court also recognized that *Affiliated Ute* involved misrepresentations as well, 406 U.S. at 152, but it would be dangerous to take this case as authority for the proposition that reliance is not required in cases of misrepresentations. First, the Court was able to find a pure omission by the defendants based on a failure to disclose the fact that they could gain financially from the transactions. The facts did not disclose any plaintiff to whom this fact was misrepresented. Thus, regardless of how many misrepresentations were made and not relied upon, this failure to disclose a material fact in light of a duty to do so was a sufficient basis for the Court to impose liability. Second, the petitioner's brief stressed that this case involved a nondisclosure and urged that the reliance requirement should therefore be dispensed with. Brief for Petitioner at 32. Even Respondent Haslem's brief agreed that if this were a case based on an omission it might be appropriate to dispense with the reliance requirement. Brief for Respondent at 27, 31. However, the petitioner went further and invited the court to dispense with the reliance requirement in all cases arising under 10b-5. Brief for Petitioner at 32. Thus, the Court had the option of eliminating the reliance requirement altogether

Thus, the Court could have been considering half-truths as well as pure omissions when it held reliance to be inapplicable to cases based on nondisclosures. Further, it is logical that the reliance requirement for half-truths be the same as that for pure omissions. In both situations the plaintiffs are misled by the defendants' failure to disclose material facts.[123]

3. *Reliance and Materiality.*—The preceding discussion of the realignment of the relationship between reliance, materiality, and causation in cases of pure omissions is based on the assumption that reliance and materiality are distinguishable concepts. To the extent that actual reliance is required, materiality is easily distinguished.[124] Even when subjectively reasonable reliance is required, materiality can be clearly distinguished in that the test for materiality is objective. The difficulty arises when the test for reliance is based on an objective reasonable man standard. Since the test for materiality is always based on an objective reasonable man standard, the two concepts are easily confused.[125] *The distinguishing factor is that the tests apply to different issues.*

In order for reliance to exist, a showing must be made that the plaintiff believed the defendant's representations to be true and that he acted because of that belief.[126] The reasonable man standard in this first context raises the issue of whether the reasonable man would have believed the representations. Materiality, on the other hand, requires a fact to which a reasonable man would attach importance in determining his course of action as to the transaction in question.[127] In this latter context, the reasonable man standard

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or dispensing with it only in the context of nondisclosures. By prefacing its holding on the reliance requirement with the statement that *Affiliated Ute* involved primarily a failure to disclose, the Court apparently chose to follow the latter option. *But see In re* Penn Cent. Sec. Litigation, 347 F. Supp. 1327, 1344 (E.D. Pa. 1972).

[123] *See* Brief for Petitioner at 32, Affiliated Ute Citizens v. United States, 406 U.S. 128 (1972). Relying heavily on *Affiliated Ute*, Reube v. Pharmacodynamics, Inc., CCH FED. SEC. L. REP. ¶ 93,704 (E.D. Pa. 1972), a case involving half-truths, held that causation-in-fact was established upon proof of an obligation to disclose, the withholding of material facts, and the active solicitation of purchasers. *Id.* at 93,092 n.17.

[124] Gilbert v. Nixon, 429 F.2d 348, 357 n.18 (10th Cir. 1970). It should be noted that reliance and materiality are treated separately in the Restatement. RESTATEMENT OF TORTS §§ 538 (materiality), 537 (reliance) (1938).

[125] One writer has suggested that "the elements of reliance are subsumed under the question of . . . materiality. . . ." *Reliance Under Rule 10b-5*, *supra* note 3, at 566. The same writer also made the point that if a fact is material, it is one "upon which a 'reasonable investor' should rely." *Id.* at 577. *See* Korn v. Franchard Corp., 456 F.2d 1206, 1212-13 (2d Cir. 1972); Mutual Shares Corp. v. Genesco, Inc., 384 F.2d 540, 544 & n.11 (2d Cir. 1967).

[126] *See* note 6 *supra* & accompanying text.

[127] *See* note 111 *supra* & accompanying text.

raises the issue of how much importance the reasonable man would attach to the information.[128]

Thus, the reasonable man standard in the context of objectively reasonable reliance is based on the reasonable man's evaluation of the accuracy of the defendant's representations. This is to be contrasted with the reasonable man standard in the context of materiality which is based on the reasonable man's evaluation of the importance of the representations in deciding on a course of action.

This suggests that by the very nature of reliance and materiality, one cannot be used to presume the other: simply because a reasonable man would believe a representation is not a sufficient basis upon which to conclude that the reasonable man would also attach importance to it.[129] The reverse is also true. This is not to say, however, that since both reliance and materiality may be used to demonstrate causation, materiality may not be substituted for reliance in cases involving pure omissions: what is presumed upon a showing of materiality is causation, not reliance.

C. *Summary*

By segregating cases involving pure omissions one can begin to appreciate the true function of materiality and reliance. Transaction causation, the element which proof of reliance seeks to establish, can be adequately established in cases of pure omissions by proof that the fact omitted was material. Proof of materiality thus serves the same function as proof of reliance, although one is not subsumed under the other.

By eliminating the necessity of proving reliance in cases of pure omissions, the courts have removed a barrier to the achievement of the purposes of 10b-5. Whereas before, the plaintiff had the burden of showing that he relied on the omission, now, under *Affiliated*

[128] The reasonable man would neither believe nor attach importance to a patently false statement. Nor would he have believed or attached importance to a misrepresentation where the facts in his possession and those which he could reasonably have discovered would have caused him to pause. Insofar as these considerations affect the believability of the misrepresentation, they are at the core of objectively reasonable reliance. Materiality, however, does not take into consideration the believability of the representation. For purposes of materiality, the fact is assumed to be accurate.

[129] However, given the existence of the first element of reliance, that the plaintiff believe the representations, materiality could be instrumental in supplying the second element of reliance, that the plaintiff acted or failed to act because of his belief in the truth of the representations. Given that the misrepresentation is one which would influence a reasonable man to act in a certain way, *i.e.*, that it is material, and given that the plaintiff believed the misrepresentation to be true, the plaintiff would normally be expected to act because of his belief. This could be rebutted, however, by proof that the plaintiff did not act as a reasonable man would have in a particular situation.

Ute Citizens, all the plaintiff need show is that the misrepresentations were material. The burden is then on the defendant to come forward with evidence that the plaintiff was not induced to enter into the transaction because of the omission.

The strength of this presumption of causation and the evidence necessary to rebut it have not been considered by the courts.[130] But regardless of the strength of the presumption, the important consideration is that the litigative burden on the defendant has been enlarged. With this greater burden, the defendant has an added incentive to fully disclose all material facts.

VI. INJUNCTIVE RELIEF

Apart from the distinctions discussed above, an action for injunctive relief introduces additional factors which have an impact on the reliance requirement.[131] Since one of the purposes of an action for damages under 10b-5 is to compensate the victim,[132] the courts are properly concerned that the injury complained of was caused by the defendant's actions. That is, the defendant must cause the plaintiff to act in a manner that ultimately results in injury.[133] If this qualification did not exist, the courts could penalize the defendant even if he were not responsible for the plaintiff's injury.

The purpose of injunctive relief, on the other hand, is not to compensate the victim of the fraud, but rather to aid in the enforcement of the disclosure standards implicit in 10b-5.[134] To achieve these policy goals it is not necessary to require reliance. The issue is not whether anyone was induced by the defendant's conduct to act in a manner which would ultimately cause injury, but instead, whether the defendant's conduct conformed to the standards required by 10b-5.

This reasoning was applied in *Mutual Shares Corp. v. Genesco*[135] to sustain an action for an injunction where there were grave doubts as to whether any causal connection existed at all. The plaintiffs

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130 *See* note 95 *supra* & accompanying text.

131 The SEC can bring actions to enjoin violations of 10b-5 since this is one of the express remedies provided by the Exchange Act. 15 U.S.C. § 78u(e) (1970). In such actions proof of reliance is not required. *E.g.*, SEC v. North Am. Research and Devel. Corp., 424 F.2d 63, 84 (2d Cir. 1970). The right of private parties to bring injunctive actions under 10b-5 has also been established. *E.g.*, Mutual Shares Corp. v. Genesco, Inc., 384 F.2d 540, 546-47 (2d Cir. 1967).

132 *See* note 17 *supra* & accompanying text.

133 *See* text accompanying notes 100-101 *supra.*

134 *See* Mutual Shares Corp. v. Genesco, 384 F.2d 540, 547 (2d Cir. 1967).

135 384 F.2d 540 (2d Cir. 1967).

bought a minority interest in S. H. Kress & Co., 94 percent of which was owned by the defendants. The plaintiffs alleged that the defendants had managed Kress in such a manner as to adversely affect the position of the minority stockholders. However, the plaintiffs neither bought nor sold any Kress stock after they realized the defendants were not acting in their best interests. Thus, there was little if any causal connection between the defendants' action and any purchase or sale of securities by the plaintiffs.

Although this was an insufficient basis on which to state a cause of action for damages, it was sufficient to state a claim for injunctive relief. The court circumvented the necessity of finding a causal connection by finding that the plaintiffs in this case were playing an "important role in the enforcement of the [Exchange] Act."[136] The court reasoned that since the SEC could maintain an action such as this without a showing of a causal connection, so could the plaintiffs since they were performing the same function as the SEC.

> [T]he claim for damages . . . founders both on proof of loss and the casual connection with the alleged violation of the Rule; on the other hand, the claim for injunctive relief largely avoids these issues, may cure harm suffered by continuing shareholders, and would afford complete relief against the Rule 10b-5 violation in the future. "It is not necessary in a suit for equitable or prophylactic relief to establish all the elements required in a suit for monetary damages."[137]

Consistent with *Mutual Shares*, the Sixth Circuit in *Britt v. Cyril Bath Co.*[138] recognized that a lower reliance standard would be appropriate in an action for injunctive relief. In *Britt* the plaintiffs sought injunctive relief, claiming that the defendant failed to disclose a secret agreement between the company and its president which depressed the price of the stock. The action was dismissed by the trial court which held that a causal connection between the alleged fraud and some resultant purchase or sale of a security was required, and that such connection was not established by an allegation of misconduct coupled with some speculative effect on the market. The Sixth Circuit reversed, holding that in private actions for injunctive relief the requirements of causation and reliance are not as strong as in actions seeking damages.[139]

Thus, injunctive relief is allowed with little, if any, showing of

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[136] *Id.* at 547.

[137] *Id.* (footnote and citation omitted).

[138] 417 F.2d 433 (6th Cir. 1969).

[139] *Id.* at 436.

reliance or causation-in-fact so that it may be included in the arsenal of legal weapons used to promote full and accurate disclosure in securities transactions. Such reasoning would not be appropriate in damage actions where the courts are faced with the additional problems that attend compensating the victim.

VII. CONCLUSION

The major reasons for allowing private recovery under rule 10b-5 are to compensate victims of fraud and to aid the SEC in the enforcement of the full disclosure standards implicit in the rule. As the elements of the common law action of deceit provide a just system of compensation to victims of fraud, it is only natural for the courts to assimilate them into private actions under 10b-5 and modify them when necessary to achieve the policy goals of the rule. To become more restrictive than common law — to require the reliance to be reasonable in situations that require only actual reliance at common law — would frustrate the basic purposes for allowing private recovery. The courts have therefore resisted the use of the reasonable reliance standard in cases other than those based on negligent misrepresentations.[140]

A plaintiff seeking to enjoin fraudulent practices, on the other hand, is not asking for compensation and thus the requirements necessary to prevent unjust recovery by the plaintiff are inappropriate. The major issue is whether the defendant is engaging in a course of conduct which 10b-5 was intended to proscribe. Reliance is, therefore, not required in this situation.

The concept of reliance in 10b-5 actions is, as are most developing concepts, subject to change. Recently, the courts have indicated their desire to deemphasize the concept of reliance so as to eliminate conflicts with the objectives of 10b-5. The realignment of the relationship between reliance, materiality, and causation, discussed above in the context of pure omissions, is one indication of this trend. Further, there appears to be little reason to restrict this realignment to cases of pure omissions. By deemphasizing reliance, the defendant is left with fewer excuses for misstating or failing to disclose material facts. To the extent that this guides potential defendants, the purposes underlying the creation of the private right of action under rule 10b-5 will have been satisfied.

TIMOTHY J. KINCAID

[140] It is arguable, however, that where rescission is requested, an actual, justifiable reliance standard should be adopted regardless of the level of scienter established. *See* note 58 *supra.*